“Failures in effective supervision preceded and contributed to the recent crisis.”

Peter Beales and Gilbey Strub
23 February 2011
How does the Crisis Management Consultation Fit into Basel and FSB Work?

Basel III

- International framework for liquidity risk measurement, standards and monitoring (Dec 2010)
- A global regulatory framework for more resilient banks and banking systems (Dec 2010)
- Minimum requirements to ensure loss absorbency at the point of non-viability (Jan 2011)

FSB

- Reducing the moral hazard posed by SIFIs (Oct 2010)
- Work stream on bail-in (summer 2011)
Ambitious, Multi-Year, 3 Stage Programme

- Stage 1: EU regime for crisis prevention and bank recovery and resolution (summer 2011)
- Stage 2: study harmonisation of EU bank insolvency regimes → resolving under same substantive and procedural rules (end 2012)
- Stage 3: creation of integrated resolution regime, possibly based on a single EU resolution authority → European Resolution Authority (2014)
  - Major centralisation / expansion of EU power (Cf. creation of US FDIC in 1933)
Crisis Management Framework for Bank Recovery and Resolution

• Increases supervisory powers to act before situation is irreversible

• Ties supervision together with resolution: where recovery not possible, resolution tools employed to ensure market exit (without state support)

• **Greatest strengths**: common resolution tools, detailed framework for group resolution

• **Concerns**: can impose changes on business if disapprove of recovery or resolution plans; vagueness of resolution fund proposal
Outline of Crisis Management Consultation

- Part 1. Scope and Authorities
- Part 2. Supervision, Preparation and Prevention
- Part 3. Early Intervention
- Part 4. Resolution Tools
- Part 5. Group Resolution
- Part 6. Resolution Funds
Overview

Prevention (part 2)  Early Intervention (Part 3)  Resolution (Part 4)

Institution sound on a micro prudential basis

Use of article 136 powers.
Special management
Specific Recovery plans and schemes

Micro prudential problem detection

Institution failing or likely to fail

First option: Ordinary liquidation

IF
Not sure 1st option could meet the resolution objectives
THEN

Second option: Orderly wind down

IF
Not sure that options 1 and 2 could meet the resolution objectives
THEN

Third option: Restructuring as a going concern

Bankruptcy code
Bridge bank
Sale of business
Debt write down

Asset transfer/asset separation

Original bank liquidated as gone concern
Original bank maintained as going concern
All of the proposals would apply to credit institutions (as per CRD) + some ‘investment firms’
- All proposals = living wills, supervision, intervention, resolution

Two possible definitions of ‘investment firm’
1. An activities + size test, or
2. Where a part of a banking group, considering 2 options:
   - **Broad**: any IF that is a member of a group that includes a credit institution,
   - **Narrower**: an IF that is either a subsidiary of an IF that falls into the 1st category (**activities** and **size**), or a subsidiary of a credit institution, and that is subject to supervision on a consolidated basis.
• Greater and more systemic use of on-site supervisory examinations
• Common methodology for stress testing
• Recovery plans
• Conflicts between consolidating and entity level supervisors → EBA mediator
Resolution Tools

- Sale, bridge, asset separation, debt write-down
  - Cf. UK Banking Act, Dodd Frank, German and Dutch statutes
- Triggers = insolvency formulation (3 options) + last resort and in public interest
- Select tool that best achieves **resolution objectives** (public interest test):
  - Continuity of essential financial services
  - Financial stability, avoid contagion
  - Protect public funds
  - Protect insured depositors
Principles to Guide Resolution Authorities

- Shareholders bear first loss
- Unsecured creditors bear residual losses
- Management replaced where appropriate
  - “bear losses in accordance with its responsibility”
- Role of normal insolvency law
- No creditor worse off than in liquidation
- Creditors within same class get same treatment
- Seek to minimise overall costs of the resolution
Resolution Powers

- Broad list of powers to implement resolution
  - Take control of bank
  - Transfer shares, debt instruments, assets, liabilities
  - Write off, cancel shares, reduce, write off debt
  - Convert debt to equity
  - Issue new shares
  - Fire management
Debt Write-Down

- Recapitalisation tool (‘bail-in’)
- Where other resolution tools not an option
- Two options: comprehensive and targeted
- Essential difference: treatment of senior debt
- Industry views vary on targeted vs. comprehensive approach
Group Resolution

- Resolution colleges
  - Establish around core of supervisory colleges
  - Group resolution authority (RA) chairs
  - Group RA responsible for EU parent
  - Forum for information sharing

- Group Resolution Authority
  - Responsible for crisis planning, preparation of resolution plans, including burden sharing
  - Power to decide whether group or entity resolution, pending which national Resolution Authority refrains from taking ‘national measures prejudicing effectiveness of group plan’
  - Group resolution scheme based on group resolution plan already in place
Group Resolution

• Opt out for national Resolution Authority
  • Resolution remains national competency
  • Resolution powers applied to individual legal entity
  • Where national RA disagrees, may take independent action where considered necessary for reasons of national financial stability

• But must consider impact of action on financial stability in other Member States
  • Give reasons for decision to resolution college
  • Where feasible within time constraints, discuss those reasons with other members of college before taking action
What About EU / Non-EU Resolution?

- Should EU strive for international coordinated approach?
  - EU agreements with 3d countries?
  - Firm by firm specific arrangements?
  - Go farther with EU cross-border framework as template for G20 regime?
  - Lehman protocol